

REVIEW

Musings on Form and Substance in Taxation

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Federal Taxation of Income, Estates and Gifts. BORIS I. BITTKER. Warren, Gorham & Lamont, Boston, 1981. 4 volumes. \$295.00.

One must spend some time with this work for Professor Bittker's accomplishment to sink in. It is staggering to have compressed so much learning into the space of four volumes. Now that this work has appeared, it is impossible to imagine engaging in a tax practice without it. Indeed, it is nearly possible to imagine engaging in tax practice with nothing else. A treatise can earn its keep if it steers us even occasionally to a sorely needed answer. Professor Bittker's new treatise will do so often, and will also provide some undiscounted intellectual pleasure along the way.

In his preface, Professor Bittker tells us that he has aimed to lay bare "structure" and "principal effects" rather than turn over every stone littering the tax terrain.¹ The treatise never gives us less than this promise, and often more. There are, of course, aspects of the income tax system—a few entire segments and many more details—that escape Professor Bittker's scrutiny. This was inevitable since the income tax provisions of the Internal Revenue Code now contain as many words as any one of Professor Bittker's four volumes. Add the Treasury Regulations to the scales, and the entire treatise is comfortably exceeded in length by the law it expounds.

Despite the inevitable limitations imposed by space, however, the eighty-two chapters already published² provide an overview of nearly all the areas of income tax that lawyers in general practice

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¹ 1 B. BITTKER, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* vii (1981).

² The outline of the work now allows for 119 chapters. Thirty-seven have been reserved. *Id.* at xv-xix. A fifth volume, on estate and gift taxation, is forthcoming.

can ever expect to face. Even tax specialists will find that considerable time will elapse between problems not encompassed by this treatise. Ultimately, of course, only time and the experience of its readers can confirm the virtues of this work. But I think I take little risk in predicting that it will be a classic.

I

There is an inference from the very undertaking of a treatise, further abetted in this case by the visible concern of the treatise with fundamentals, that Professor Bittker has aimed for a work of permanence. In this he faced the bane of treatise writers: the impermanence of the law.* Americans are, as peoples go, among the readiest to adopt new religions and new tax laws. Since the first four volumes of Bittker's treatise appeared last year, there have been no fewer than four major tax enactments³ and a number of minor ones.⁴ In the summer of 1981, within months of the appearance of the treatise, Congress produced a law⁵ that at once tamed the thrust of progressive taxation for individuals,⁶ introduced entirely new principles of cost recovery for business assets,⁷ exempted most Americans working abroad from United States

* [EDITORS' NOTE: This phenomenon is occasionally the bane of reviewers and law review editors as well. After this issue went to press, Congress enacted the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 51 U.S.L.W. 5 (1982) (to be codified in scattered sections of 26 U.S.C.), which substantially modified legislation passed only last year. Professor Isenbergh's discussion of recent tax enactments accordingly does not include changes wrought by the 1982 Act.]

³ Economic Recovery Tax Act of 1981 ("ERTA"), Pub. L. No. 97-34, 95 Stat. 172 (codified in scattered sections of 26 U.S.C.A. (West Supp. 1982)); Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, 94 Stat. 3389 (codified in scattered sections of 26 U.S.C.A. (West Supp. 1982)); Foreign Investment in Real Property Tax Act of 1980, Pub. L. No. 96-499, 94 Stat. 2599 (codified in scattered sections of 26 U.S.C.A. (West Supp. 1982)); Installment Sales Revision Act of 1980, Pub. L. No. 96-471, 94 Stat. 2247 (codified in scattered sections of 26 U.S.C.A. (West Supp. 1982)).

⁴ I.R.C. § 66 (1982) (abandoned spouses); *id.* § 195 (amortization of start-up expenditures); *id.* § 274(h) (foreign convention expenses); *id.* § 861(e) (source of income from certain aircraft); Act of Dec. 28, 1980, Pub. L. No. 96-603, 94 Stat. 3503 (codified in scattered sections of 26 U.S.C.A. (West Supp. 1982)) (qualified foreign pension plans).

⁵ ERTA, Pub. L. No. 97-34, 95 Stat. 172 (codified in scattered sections of 26 U.S.C.A. (West Supp. 1982)).

⁶ *Id.* § 101(a), 95 Stat. at 176-82 (codified at I.R.C. § 1 (West Supp. 1982)) (maximum marginal rate of 50% for all taxpayers; most middle class incomes taxed in range between 40% and 50%).

⁷ *Id.* § 201(a), 95 Stat. at 203-19 (codified at I.R.C. § 168 (West Supp. 1982)). Coupled with a special provision for the sale of tax benefits between corporations, *id.* § 201(a), 95 Stat. at 214-16 (codified at I.R.C. § 168(f)(8) (West Supp. 1982)), the new cost-recovery regime effectively repeals the corporate income tax for capital-intensive industries.

taxes,⁸ and removed all but large estates from the reach of transfer taxes.⁹ The full effect of these changes, even should they survive further statutory modification, will be years in the unfolding.¹⁰

It compounds the task of a treatise writer that different observers necessarily have different vantage points on the tax system. Lawyers, tax reformers, economists, and ordinary taxpayers are apt to respond to the 1981 changes in their own ways. As embodiments of tax policy, the recent changes are a breathtaking measure of shifting political tides. The new regime is especially striking against the background of the Tax Reform Acts of 1969¹¹ and 1976,¹² which together represent the statutory high water mark of the "tax reform" movement. 1969 and 1976 marched under the banner of various equities, both vertical and horizontal, of curbing abuse, closing shelters, and aligning taxes more squarely with the true economic benefits received by taxpayers. 1981 rises under the sign of *supply*: cut taxes everywhere and watch productivity swell in their wake.¹³

* *Id.* § 111(a), 95 Stat. at 190-94 (codified at I.R.C. § 911(b) (West Supp. 1982)) (allowance, increased to \$95,000 by 1986, and housing costs excluded from taxable income of Americans residing abroad).

* *Id.* §§ 401(a), 403(d), 95 Stat. at 299-300, 301-05 (codified at I.R.C. §§ 2010, 2056 (West Supp. 1982)). The unified credit allowing tax-free transfers up to \$600,000, in conjunction with an unlimited marital deduction, allows estates of up to \$1,200,000 to escape tax.

¹⁰ The first cumulative supplement to Professor Bittker's treatise fully reflects these statutory changes. B. BITTKER, *supra* note 1 (Cum. Supp. No. 1, 1982) (text, tables, & index vol.).

¹¹ Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (codified as amended in scattered sections of 26 U.S.C. (1976)).

¹² Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (codified as amended in scattered sections of 26 U.S.C. (1976)).

¹³ The survival of some of the 1976 rules in a Code now adorned with supply-side provisions sometimes creates a curiously mottled statutory pattern. For example, the 1976 Act placed stringent limitations, amounting nearly to a prohibition, on the transfer by sale of tax benefits in the form of loss carry-forwards from losing enterprises to successful ones. *Id.* § 806(e), 90 Stat. at 1599-1605 (codified at I.R.C. § 382 (1976)). For those who feel strongly about economic efficiency (and one tends to meet more of them these days) this is a dubious idea.

If we assume that the tax system should distort investment decisions as little as possible, a more forgiving view of trading in tax losses seems better. Under the 1976 limitations, some firms, especially young and undiversified ones (those least likely to have any use for tax benefits not transferable to others), may be denied any tax benefit for some portion of their losses. To the extent that these benefits are denied to investors (who will of course be taxed in full on their gains), investors are in effect risking whole dollars to make dollars diminished by taxation, whereas in a tax-free world they would stand to gain or lose dollars of the same value. Under the 1976 limitations on the transfer of tax losses, therefore, the initial decision by some firms to invest may be different from the one that would be made in a tax-free world. For a persuasive analysis of this problem, see Campisano & Romano, *Re-*

Changes in the basic thrust of our tax system are not likely to cause tax lawyers much concern, however. For them, there is a living to be made by aligning the interests of clients with the movements of the Code, however jagged or circuitous these turn out to be. A change in the law with momentous effects on the tax environment—for example, a halving of all rates—would pass nearly unnoticed by practitioners if it left much of the inner plumbing of the Code undisturbed.

In his treatise, Professor Bittker responds principally to the needs of those who use the Code rather than those who make it. He does not set himself up as a prophet of tax policy or public finance, although the treatise contains admirable introductory chapters on both.¹⁴ He has staked eminently practical ground, which will assure a large readership at the outset, but where it is hardest to preserve a work from unplanned obsolescence.

Even within the terrain of workaday tax lawyers, however, some questions are nearer the core of the tax system than others and are likely to remain of more permanent concern. These perennial questions include the nature of income, the tax benefit principle, annual accounting, recovery of capital, realization, claim of right, the timing of income and deductions, and so on. WIN credits and Asset Depreciation Ranges may come and go, but some basic notions will survive as long as income remains the basis of our tax system. An understanding of these notions—some of which I had the good fortune to encounter first at the losing end of Socratic exchanges with Professor Bittker himself—makes up the indispensable knowledge and intuition of tax lawyers. Professor Bitt-

couping Losses: The Case for Full Loss Offsets, 76 Nw. U.L. Rev. 709 (1981).

The 1981 Act, reflecting different biases, cuts much the other way and allows corporations freely to sell tax benefits resulting from its generous allowances for capital recovery. See *supra* note 7. This possibility results from an extreme relaxation of the rules governing leases of property. Under the 1981 Act, agreements between corporations will be recognized as "leases" for tax purposes regardless of their economic or legal character for other purposes. ERTA § 201 (codified at I.R.C. § 168(f)(8)(A) & (F) (West Supp. 1982)). Thus a corporation can become the "owner" and ostensible lessor of business assets, thereby obtaining the tax benefits of capital recovery, without having the usual economic or legal attributes of ownership. Such agreements can be structured to produce the same effect as a transfer of tax benefits from one corporation to another for a fee. These sales of tax allowances may permit young and undiversified firms, or old and ailing ones, to derive benefit from what might otherwise be accumulations of losses made useless by the Code's limitations on transfers of losses. The 1976 rules were not repealed, however, so the Code still purports to limit the survival of loss carry-forwards of corporations whose stock has changed hands. The 1981 rules are an overlay on the prior rules that allows a partial end run around them.

¹⁴ 1 B. BITTKER, *supra* note 1, chs. 1-4.

ker's treatise will last, I believe, because of its systematic concern for these basic themes of taxation.

II

Among the tax perennials, one especially persistent question is how the tax laws should be applied to transactions that appear designed to defeat them. Most major statutes raise problems of interpretation, of course, but the quest for "substance" through the distracting haze of "form" has attracted a particularly intense scrutiny in tax matters.¹⁵

As a starting point, there is almost universal assent among tax lawyers and theorists that the revenues should not be defeated by certain entirely artificial maneuvers. We are assured—and it would be hard to demur—that the "substance" of events should determine their tax consequences and that any other principle would expose the Treasury to obvious manipulations. Certain presumptions, generally favoring the Treasury, are thought to flow from the order of things. Both on matters of fact and interpretation, a taxpayer must sustain a position once challenged by the tax authorities, and that burden is entirely reasonable.¹⁶

The harder question, however, is the nature of the defense the taxpayer must produce. From a clean slate, it might be thought sufficient for the taxpayer to show that a transaction, fairly characterized, is encompassed by the statute and that the statute, by its terms, yields the desired result. Things are not so simple, though, and much has been made to turn on the nature of the taxpayer's desire. There has developed a welter of rules and extrastatutory standards that impose particular scrutiny on transactions with results unfavorable to the Treasury. These standards are enshrined in celebrated cases—*Gregory*,¹⁷ *Court Holding*,¹⁸ *Bazley*,¹⁹ *Earl*,²⁰ *Goldstein*²¹—that stand as bulwarks against overreaching by taxpayers. It is from these cases that the basic weapons in the Com-

¹⁵ One man's tax shelter being everyone else's budget deficit, all taxpayers ultimately have an interest in the reasonable interpretation of the tax laws.

¹⁶ See, e.g., *Welch v. Helvering*, 290 U.S. 111, 115 (1933).

¹⁷ *Gregory v. Helvering*, 293 U.S. 465 (1935). See *infra* notes 33-49 and accompanying text.

¹⁸ *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945). See *infra* notes 50-65 and accompanying text.

¹⁹ *Bazley v. Commissioner*, 331 U.S. 737 (1947).

²⁰ *Lucas v. Earl*, 281 U.S. 111 (1930).

²¹ *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966), cert. denied, 385 U.S. 1005 (1967). See *infra* notes 65-79 and accompanying text.

missioner's arsenal are derived—the business purpose doctrine, the step transaction doctrine, “substance over form,” and others. The effect of these doctrines is the existence alongside the Internal Revenue Code of an additional (and somewhat autonomous) set of principles for deciding tax disputes.

Professor Bittker is a faithful reporter of these doctrines. He recognizes that a number of principles extrinsic to the Code (narrowly conceived) now govern its application.²² There remains the question of the intellectual force of these principles in their present sway. On this question—perhaps *the* question among tax perennials—Bittker takes a restrained position, a posture fully justified, however, by the stated object of his work.

Professor Bittker starts from the readily accepted limitations of pure literalism: words shorn of all context are not always self-construing.²³ From there he proceeds to a description of the prevalent doctrines. He describes the judicial search for “substance” in tax matters with a caution bordering on detachment.²⁴ If one had to infer Bittker's own views on the issue, however, one might be able to extract from the pages of his treatise a lukewarm endorsement of the general approach taken by the courts in this area. But perhaps I find this so only because Professor Bittker describes in mild tones doctrines and cases at which I balk. Certainly nothing in Professor Bittker's goal of being “concise, lucid, and accurate”²⁵ required him to betray any intellectual uneasiness aroused by the doctrines he relates.

To Professor Bittker's dispassionate summary of the law I cannot resist adding my own view that several of the touchstone cases on form and substance in taxation are flawed in principle and serve neither taxpayers nor the Treasury. What follows here, in support of this view, is an excursion—dotted with a few generalizations—through a handful of cases widely regarded as embodying important glosses on the Internal Revenue Code.

III

The source of the problem is that the tax laws necessarily have a limited number of terms, but must be applied to a nearly unlimited range of transactions. Many of the basic terms of the Code are therefore imported into it with their contours already set. For ex-

²² 1 B. BITTKER, *supra* note 1, at 4-18 to 4-25.

²³ *Id.* at 4-2.

²⁴ *Id.* at 4-18 to 4-56.

²⁵ *Id.* at vii.

ample, the Code taxes a "sale" without defining what a sale is;²⁶ business and commercial experience supply that knowledge. In the terms of *Welch v. Helvering*,²⁷ life tells us what a sale is. It follows that someone who has engaged in a transaction more reasonably characterized as a license or a lease cannot make it a "sale" simply by writing that word at the top of an agreement. The point is simple enough: where the Code follows life, life is determinative. The underlying idea—that it does not matter what things are called—is common to all law. No label can make a diamond of a rhinestone. This principle is more than sufficient to defeat transactions that are simply shams.²⁸

In addition to reflecting the world, statutes are also creatures of art that impose their own form on the world. The Internal Revenue Code tells us that a "dividend" is a distribution by a corporation out of the profits of the current taxable year.²⁹ That being so, it makes no difference that the corporation may have lost money from its operations overall and that an economist might assure us that a distribution in such circumstances was a return of capital. A distribution out of current profits is a dividend because the statute says so.

In almost all statutes one finds an amalgam of references to the world and relations created by the statute itself; a mixture, if you will, of life and art. Finding and isolating these two elements is much of what the problem of form and substance is about. The normal process of applying a statute to a transaction consists in determining first, where the statute responds to the transaction, and second, what this response does to the transaction itself.

Things become difficult when life imitates art, as it often does. When someone calls a dog a cow and then seeks a subsidy provided by statute for cows, the obvious response is that this is not what the statute means. It may also happen that rich people who would not otherwise have cows buy them to gain cow subsidies. Here, when people say (as they do) that this is not what the statute means, they are in fact saying something quite different.

Many of the difficulties that bedevil the pursuit of "substance" and "form" in taxation stem from the assimilation of these

²⁶ I.R.C. § 1001 (1976).

²⁷ 290 U.S. 111, 115 (1933).

²⁸ The "sham transaction" doctrine means nothing more than that labels are not determinative. The term itself is used loosely, though, and in some cases is invoked in connection with doctrines of broader reach. *E.g.*, *Helvering v. Gregory*, 69 F.2d 809, 811 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935); *see infra* notes 33, 48.

²⁹ I.R.C. § 316 (1976).

two patterns. From the beginning of taxation people have sought advantage in calling one thing another. To avoid a tax imposed on compensation, for example, people would call it a gift.³⁰ The principle of following "substance" rather than "form" has always meant sweeping aside pretenses of this sort.

In another class of cases what was done apparently falls within the statute, but results in a bad thing.³¹ Although they differ among themselves on what constitute "bad things," people dislike them enough to strain to suppress them when possible. Many bad things, however, are precisely what they purport to be, and therefore cannot be swept aside as shams. Here the inclination of one who feels strongly is to invoke some more general feature of the law, for example the "intent" (or perhaps nowadays the "deep structure"³²) of the statute, to conclude that the bad thing ought not to be.

The Treasury, naturally enough, regards the reduction of tax obligations as a ubiquitous bad thing. Because there are many different ways of engaging in transactions with roughly similar ends, some more heavily taxed than others, the world in the Treasury's view is a mosaic of bad things. None of this is at all surprising. More surprising, however, is the success the Treasury has had in litigation in establishing that the problem of distinguishing between transactions fairly characterized and impostors is the same sort of intellectual problem as the difference between good and bad things generally, and that both fall within the general rubric of form and substance.

IV

One of the cases that opened this path for the Treasury, and also perhaps the case most widely invoked as a source of first principles on form and substance, is *Helvering v. Gregory*.³³ In *Greg-*

³⁰ See, e.g., *Commissioner v. Duberstein*, 363 U.S. 278, 281-82 (1960); *Noel v. Parrott*, 15 F.2d 669, 669 (4th Cir. 1926).

³¹ See, e.g., *Goldstein v. Commissioner*, 364 F.2d 734, 741 (2d Cir. 1966), cert. denied, 385 U.S. 1005 (1967); see *infra* notes 65-79 and accompanying text.

³² See Kingson, *The Deep Structure of Taxation: Dividend Distributions*, 85 YALE L.J. 861 (1976); *infra* note 89.

³³ 69 F.2d 809 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935). *Gregory* was by no means the first case to attempt a standard for wresting substance from the jaws of form. Earlier Supreme Court opinions from the pen of Justice Holmes had asserted that tax disputes should not turn on "technicalities," "attenuated subtleties," or "the refinements of title," but on the "import and reasonable construction of the taxing act" or "actual command over the property taxed." *Corliss v. Bowers*, 281 U.S. 376, 378 (1930); *Lucas v. Earl*, 281 U.S. 111, 114 (1930); *Irwin v. Gavitt*, 268 U.S. 161, 165 (1925). In these cases, however, Holmes simply

ory, assets had been separated from a corporation by the creation and distribution of shares of a second corporation, a transaction ostensibly meeting the requirements of a "reorganization" under the Revenue Act of 1928.³⁴ As such, the separation of assets would be tax-free, and the subsequent liquidation of the second corporation would give rise to capital gains in the hands of the shareholder who had received the distribution of shares. The result of the transaction, however, was the same as a simple dividend distribution, and the Commissioner sought to tax it as such.

For the Board of Tax Appeals, the problem in *Gregory* was whether this transaction should be measured by life or by art.³⁵ The distribution of shares fitted precisely within the definition of a tax-free "reorganization" in the 1928 Act. The statute did more than merely attach tax consequences to the occurrence of a "reorganization"; it purported to say what the term "reorganization" meant. The Board of Tax Appeals thought it inescapable to regard the notion of "reorganization" as a creature of the statute itself, and concluded that a reorganization was precisely what had occurred.³⁶ Judge Sternhagen's opinion rested on the principle that "a statute so meticulously drafted must be interpreted as a literal expression of the taxing policy and leaves only the small interstices for judicial consideration."³⁷ The Second Circuit, with Learned Hand writing for a panel of judges of great intellectual prestige,³⁸ reversed in a decision that has left echoes in every corner of the tax law.³⁹

A difficulty with *Gregory* is that these echoes reflect an opinion of greater literary power than sharpness of doctrine. There are two strands in *Gregory*, corresponding roughly to the two different views of form and substance sketched above. At the outset, *Greg-*

found in broader principles of interpretation confirmation of a technical analysis already unfavorable to the taxpayer. At least as a matter of tone, though, the Holmes opinions leave open the possibility that the terms of the statute (narrowly conceived) might in a proper case give way to other considerations.

³⁴ Revenue Act of 1928, ch. 852, § 112(g), 45 Stat. 791, 818 (repealed 1934); *id.* § 112(i), 45 Stat. at 818 (current version at I.R.C. § 368(a)(1) (Supp. IV 1980)). The question might well have been asked whether the overall transaction arose under a "plan" of "reorganization" as required by section 112(g) of the Act, the requirement of a "plan" being arguably in addition to the requirement that a transaction qualify as a "reorganization," but the point was apparently not made.

³⁵ *Gregory v. Commissioner*, 27 B.T.A. 223 (1932), *rev'd*, 69 F.2d 809 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

³⁶ *Id.* at 225-26.

³⁷ *Id.* at 225.

³⁸ Judges Thomas W. Swan and Augustus N. Hand sat with Hand.

³⁹ 69 F.2d 809, 810-11 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

ory raises the question whether the notion of a "reorganization" in the 1928 Act is simply a creature of the statute or whether it imports something from life—life in this case being the world of business in which "reorganizations" occur. Within the terms of the statute, the taxpayer had a winning case because she had done everything the statute required. If, however, we view the statute not as an exhaustive definition of reorganizations but as incorporating something from the world of business, the government had a strong case. Certainly what happened in *Gregory* did not much look like the sort of adjustment of a business that the notion of a "reorganization" would bring to mind if derived from the business world and not solely from the statute.

If the question in *Gregory* is so framed, the case is a close one. Having said that the case was close, though, I also think the Board of Tax Appeals decided it correctly. The 1928 Act clearly purported to *define* reorganizations.⁴⁰ The contrast with the Revenue Act of 1921, which purported only to enumerate certain transactions *included* within the term "reorganization,"⁴¹ cuts against any suggestion that the language of the 1928 Act was accidental and not entitled to full effect.⁴² Certainly the IRS would not have acknowledged as a "reorganization" any transaction falling outside the statutory range but similar in business effect. The definition of a "reorganization" in the statute happened to be broad enough to include transactions similar in pattern to the reorganizations conducted in the world, even though they aimed at different ends.

Seen as a case on the scope of the term "reorganization" in the 1928 Act, *Gregory*, whether rightly or wrongly decided, is not doctrinally startling. The term "reorganization" had already been found, in earlier cases on continuity of shareholder interest, to be bounded to some extent by its antecedents in the world.⁴³ Judge Hand's oft-cited metaphor that "a melody is more than the notes"⁴⁴ essentially reasserts this and might have been sufficient to set aside Mrs. Gregory's transaction as too sterile to amount to a

⁴⁰ Revenue Act of 1928, ch. 852, § 112(i)(1), 45 Stat. 791, 818 (current version at I.R.C. § 368(a)(1) (1976)).

⁴¹ Revenue Act of 1921, ch. 136, § 202(c)(2), 42 Stat. 227, 230 (current version at I.R.C. § 368(a)(1) (1976)).

⁴² The legislative history is not particularly helpful, beyond suggesting that a definition of *reorganizations* is indeed what Congress intended.

⁴³ See *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462, 469-70 (1933); *Cortland Specialty Co. v. Commissioner*, 60 F.2d 937, 939-40 (2d Cir. 1932), *cert. denied*, 288 U.S. 599 (1933).

⁴⁴ *Gregory*, 69 F.2d at 811.

reorganization in the business sense.

There are, however, two sentences in the case that enlarge its reach: "But the underlying presupposition is plain that the readjustment shall be undertaken for reasons germane to the conduct of the venture in hand, not as an ephemeral incident, egregious to its prosecution. To dodge the shareholders' taxes is not one of the transactions contemplated as corporate 'reorganizations.'"⁴⁵ These sentences contain in germ a theory of business purpose and tax avoidance. Although the boundaries of these notions do not emerge fully drawn, the intentions underlying the two are obviously linked in this passage, the latter becoming more sinister in the absence of the former. The "venture in hand" must be the conduct of the underlying business of the corporation from which the distribution was made.⁴⁶

As an abstract proposition, it is not immediately obvious why a division of corporate assets would have to be germane to the conduct of the remaining business or even what it means to be germane. Businesses might well be perfectly indifferent whether other assets were held in corporate solution along with them, and will hardly be affected whether a separation of assets occurs by reorganization or by dividend. The second sentence, of course, largely clarifies what is meant by "germane" in its suggestion that the end of a reorganization as such cannot be tax avoidance.

This also is far from self-evident, however, for the whole point of the reorganization provisions in the Code is to make certain transactions tax-free. To be sure, the range of dividend taxation is cut back as a result; but it was in response to patterns otherwise taxed as dividends that the reorganization provisions came into being in the first place.

The transaction in *Gregory* was doubtless economically equivalent to a dividend distribution, and to that extent the reorganization served principally to avoid the more onerous dividend tax. As a basis for resolving matters of form and substance, however, economic equivalence is untenable. The Code creates numerous tax differences between economically equivalent transactions.⁴⁷ The very decision to incorporate a business often entails a choice between two economically equivalent ways of pursuing a profit.

⁴⁵ *Id.*

⁴⁶ To treat the "venture in hand" as the reorganization itself makes Hand's statement meaningless.

⁴⁷ *E.g.*, I.R.C. §§ 302, 305 (1976) (same result achieved by stock redemption or by stock dividend taxed respectively as capital gain or dividend).

Whatever its precise boundaries, the inquiry of the court in *Gregory* remained whether the thing done fell within the statute. In resolving that question, Judge Hand apparently found in the tax laws a generalized requirement that a reorganization be free of certain bad features. This can be restated more broadly as a principle that where the character of a corporate transaction is ambiguous, the Code somehow "prefers" a dividend to a capital gain, the latter being a matter of grace. So viewed, *Gregory* can be treated as a fairly traditional exercise in statutory interpretation. The opinion itself concluded squarely that Mrs. Gregory's transaction did not fall within the statutory term "reorganization" and was therefore a "sham."⁴⁸ The Supreme Court's affirmance seized particularly on this aspect of the case and, by repeatedly characterizing the underlying transaction as a "device," a "masquerad[e]," or an "artifice," tended to bring *Gregory* back within the range of "sham" cases.⁴⁹

On balance, however, it is hard to view *Gregory* as simply a sham transaction case. Even though Judge Hand ostensibly operated entirely within the statute, the specific definitions of the 1928 Act ultimately surrendered to an almost open-ended statement of statutory purpose as the basis for decision.

V

Subsequent decisions have found in *Gregory* a broad mandate to attack perceived "bad" features of transactions, however firmly anchored within the terms of the Code. Reflecting perhaps the two strands within *Gregory*, a pattern common to many of the important later cases on "form" and "substance" is the coexistence within them of a narrow and a broad holding. The narrow holding is usually the ferreting out of some sham or other that justifies a recasting of a transaction. The broad holding is typically the assertion of some overriding principle of taxation that denies the taxpayer the wanted result, even assuming a transaction perfectly fitted within the terms of the statute.

Generalizing about these cases, one can say that in their nar-

⁴⁸ 69 F.2d at 811. Judge Hand, in later pronouncements about *Gregory*, was often at pains to construe it as a simple "sham" case. See *Chisholm v. Commissioner*, 79 F.2d 14, 15 (2d Cir. 1935) (question in the Supreme Court's opinion in *Gregory* was whether transaction was in fact what it appeared to be in form). In other places, however, he treated the case as containing the entire "business purpose" doctrine. *Commissioner v. Transport Trading & Terminal Corp.*, 176 F.2d 570, 572 (2d Cir. 1949) (*Gregory* requires business purpose for transaction to be effective for tax purposes).

⁴⁹ 293 U.S. at 465, 470, 471.

row holdings they are often wrong. Courts have been too quick to recast transactions that in fact deserved the character assigned them by the taxpayers. This in itself is not a serious problem, except for the taxpayers. A bad result in any given case is correctable later as transactions become better understood and more carefully managed. But there are also errors of principle in these cases, more troublesome in their permanent effect.

A case that epitomizes this pattern is *Commissioner v. Court Holding Co.*⁵⁰ In that case, negotiations for the sale of a piece of property by a corporation culminated in an oral agreement.⁵¹ When the parties met to reduce the agreement to writing, however, the corporation's attorney advised the buyers that the sale could not go through because of adverse tax consequences. Instead, the corporation was liquidated the next day and its properties were distributed to its shareholders in exchange for their stock; the shareholders then sold the properties to the buyers on terms essentially the same as those previously negotiated with the corporation. If the transaction could properly be regarded as a liquidation of the corporation, followed by a sale of its properties by the shareholders, the corporate-level tax would be avoided. The Commissioner, however, insisted that the corporate-level tax be paid as though the corporation had sold the property before the liquidation and had distributed the cash proceeds to the shareholders in liquidation.⁵² The Supreme Court upheld the Commissioner.⁵³

One can find in *Court Holding* a narrow decision, largely factual, sounding in the sham transaction doctrine. So conceived, the Court's opinion merely asserts that, based on the overall record, no actual liquidation of the company occurred before the sale and that the sale was actually made by the corporation itself.⁵⁴ As such, there is nothing sinister about the *Court Holding* case. It is merely

⁵⁰ 324 U.S. 331 (1945).

⁵¹ *Id.* at 333.

⁵² 2 T.C. 531, 535 (1943), *rev'd*, 143 F.2d 823 (5th Cir. 1944), *rev'd*, 324 U.S. 331 (1945). Under the tax laws then in effect, *see* I.R.C. § 115(c) (1939), the pattern insisted upon by the Commissioner gave rise to taxable gain both for the corporation and the shareholders. *See* 2 T.C. at 541.

⁵³ 324 U.S. at 333-34.

⁵⁴ *Id.* *Court Holding* can be read even more narrowly as a case on the scope of appellate review of facts found by the Tax Court. The Tax Court "found" that the property had been sold by the corporation, 2 T.C. at 537, an implausible finding on the record, but not beyond belief. The Supreme Court might have concluded that the Tax Court's findings should be disturbed only if patently wrong. *See, e.g., Dobson v. Commissioner*, 320 U.S. 489, 501-02 (1943) (Tax Court's findings of fact stand on review as long as there is a "rational basis" for them in the record). So conceived, *Court Holding* might be correctly decided, although having nothing to do with form versus substance.

wrong. On the facts as summarized by the Supreme Court (and apparently found by the Tax Court) it is fairly plain that a liquidation really did occur.⁵⁵ The conclusion would be different if, for example, the corporation had in fact sold the property and the taxpayers, as an afterthought, had attempted to trump up a liquidation. The Court was apparently misled by the rapid succession of events into thinking that a liquidation that briefly precedes a sale is somehow less a liquidation than one that precedes it by a long period, a notion readily dispelled upon reflection.⁵⁶

The Court was not satisfied with a narrow and wrong decision, however. There is a larger aspect of *Court Holding*, far more difficult to state and limit. Starting from the proposition that "[t]he incidence of taxation depends on the substance of a transaction,"⁵⁷ the opinion asserted that the "means employed to transfer a legal title" cannot by themselves govern the tax consequences of a sale.⁵⁸ The liquidation of the corporation, in the Court's view, did nothing more than set up the shareholders as a "conduit" for the passage of title to the buyers, and as such could be disregarded as a "mere formalism[]." ⁵⁹

These propositions must have substantial superficial appeal, because they are accepted by an overwhelming majority of tax lawyers. But they are not tenable. All that the liquidation of a corporation ever entails is a transfer of title in its assets. When an artifi-

⁵⁵ Whether such an erroneous inference from the facts would require reversal is another matter.

⁵⁶ Even here the Supreme Court's holding can be justified on the narrower ground that findings of fact by the Tax Court should be respected as long as they are warranted by the record, even though the conclusion the Tax Court drew can be shown to be wrong as a practical matter. The Supreme Court has held that any latitude in resolving factual issues in tax cases belongs to the Tax Court in its greater expertise, and that deference to those findings is therefore due. *Dobson v. Commissioner*, 320 U.S. 489, 501-02 (1943). This interpretation of *Court Holding*, of course, goes only to the scope of appellate review. See *supra* note 54.

It is an essential aspect of *Court Holding* that because the agreement was oral, there was no contract, enforceable against the corporation, to sell the property. There was thus no assignment of a contract already in force from a corporation to its shareholders, who might then be regarded as doing nothing more than fulfilling the corporation's obligations. Even in such a case it would not be obvious that the corporation was the seller; however, this hypothesis has no bearing on *Court Holding*, in which the only enforceable sale was made by the shareholders after liquidation.

On its narrow, factual basis, *Court Holding* was corrected in a later case, *United States v. Cumberland Pub. Serv. Co.*, 338 U.S. 451 (1950), where the Supreme Court found, on essentially indistinguishable facts, that liquidation and sale had occurred in the order urged by the taxpayer.

⁵⁷ 324 U.S. at 334.

⁵⁸ *Id.*

⁵⁹ *Id.*

cial entity disappears, there results a change in the form of ownership of property. Indeed, it is hard to think of what else happens in a liquidation other than a change in the formal indicia of ownership.⁶⁰ This central fact—that liquidations of corporations are purely formal creatures of law—was apparently misunderstood by the Supreme Court. There is no specific physical event to which liquidations correspond. The same people may remain in control of the same property both before and after. To describe the passage of title pursuant to a liquidation as a “mere formalism” is to deny in effect that there can ever be a “real” liquidation.

In order to avoid the *reductio* implicit in *Court Holding*, later decisions⁶¹ and commentators⁶² have derived a somewhat different principle from the case. *Court Holding* is read to mean that the “substance” of a transaction can be found in the negotiations leading up to it, that from these negotiations the essential character of the transaction can be determined, and that once determined, it can override both the formal mechanics and purported effect of the transaction as structured by the parties. This is how the IRS⁶³ and most tax lawyers now understand *Court Holding*.⁶⁴ Lawyers routinely advise clients, once a corporation has taken a step or two toward a transaction with another party, that any form of the same transaction between the corporation’s shareholders and the same party may be imputed back to the corporation. If it turns out that a transaction with the shareholders would bring better tax consequences, lawyers will frequently advise negotiating an entirely new transaction, with a different party, for fear of the penumbras of *Court Holding*. The lawyers may also stress how much difficulty the client would have saved by consulting them earlier.

The notion that negotiations are somehow part of the “substance” of a transaction is baffling. Negotiations can go on interminably and lead to a transaction or none, as the case may be. At the

⁶⁰ In most states no conveyance is necessary; title to properties automatically vests in shareholders upon liquidation. See 16A W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 8134 (rev. perm. ed. 1979).

⁶¹ See, e.g., *Waltham Netoco Theatres, Inc. v. Commissioner*, 49 T.C. 399, 404-05, *aff’d*, 401 F.2d 333 (1st Cir. 1968).

⁶² See, e.g., Mintz, *Recent Developments Under Court Holding and Cumberland Public Service Co. Cases—Sale of Assets or Stock*, 11 INST. ON FED. TAX’N 873, 876-84 (1953).

⁶³ See Rev. Rul. 69-172, 1969-1 C.B. 99.

⁶⁴ Applied to the facts of *Court Holding*, this principle would no longer defeat the taxpayer. Section 337 eliminates recognition of gain by a liquidating corporation, regardless of the order of liquidating and sale. I.R.C. § 337 (West Supp. 1982). The principle of *Court Holding* is still applied to recast transactions other than complete liquidations. E.g., Rev. Rul. 69-172, 1969-1 C.B. 99.

last minute the parties can storm out and war can ensue. In fact, *Court Holding* could be invoked to show that the Trojan War never was, or at least could be set aside as a sham, because it followed a series of negotiations tending to peace. However long the negotiations, the parties can change their minds in an instant and make a deal never before contemplated. Indeed, the longer the negotiations, the more likely the transaction actually consummated will be different from any one previously canvassed by the parties.

On close scrutiny, the reasoning in *Court Holding* simply collapses. The case does hardly more than proceed directly from the proposition that substance must prevail over form to the conclusion that the taxpayer's transaction cannot stand.

Although couched in the language of "form" and "substance," *Court Holding* has little to do with either of these things. Rather, it requires that the Treasury not be deprived of the benefit of an error that a taxpayer was about to make and corrected too late. Although it is not immediately obvious what the Court meant by "substance," in practice *Court Holding* called up a new set of forms to replace those less appealing to the Court. If the negotiators of a transaction are careful to assert from the start on whose behalf they negotiate, *Court Holding* can be tamed. Such an assertion is itself a formality and can be regarded as a Miranda warning of sorts, necessary to make certain transactions operative under subchapter C.

VI

Gregory and *Court Holding* encapsulate in the end an essentially aesthetic response to attempts by taxpayers thought unworthy of success. Both cases are, however, couched in the language, at least, of traditional statutory interpretation. *Gregory* purports to be striving for the *meaning* of the tax statute. *Court Holding* purports to lay bare what "really happened" in a transaction. A later case, *Goldstein v. Commissioner*,⁶⁵ took a large step in severing the question of form and substance altogether from one of dissecting transactions and the Internal Revenue Code.

Tillie Goldstein won \$140,000 in the Irish Sweepstakes in 1958.⁶⁶ Shortly thereafter she borrowed somewhat less than one million dollars at four percent from banks, prepaying several years'

⁶⁵ 364 F.2d 734 (2d Cir. 1966), *cert. denied*, 385 U.S. 1005 (1967).

⁶⁶ *Id.* at 736.

interest of \$81,000 in cash.⁶⁷ With the loan proceeds she bought at a discount one million dollars' worth of 1.5% United States treasury notes, with maturities of three and four years.⁶⁸ The notes were pledged as security for the bank loans. Mrs. Goldstein hoped that the large interest prepayment would provide a deduction to offset her sweepstakes winnings, while the interest she received on the treasury notes would be reported annually. There was also the possibility of a capital gain upon retirement of the notes. What Mrs. Goldstein attempted in effect was home-made income averaging and deferral, but the plan would succeed only if the \$81,000 in prepaid interest was deductible.

To the Tax Court the interest payments were a sham.⁶⁹ It reasoned that the bank had, in fact, invested directly in the treasury notes and had received from Mrs. Goldstein a fee for the service of donning the facade of a lender.⁷⁰ The Tax Court was almost surely wrong on this point, and the Court of Appeals so found.⁷¹ Interest on the bank loans really had been paid, the bank had no rights in the treasury notes except as collateral, and it was nearly impossible not to treat the indebtedness of Mrs. Goldstein as genuine.

Having restored the character of interest to the amount paid by Mrs. Goldstein, the Court of Appeals was still not satisfied to let her win the case. The overall borrowing and purchase of treasury notes held out quite slender prospects of an economic profit for Mrs. Goldstein. The tax advantage of an interest deduction in the year of the sweepstakes win obviously was the motivating force in the transaction. Following the language of *Gregory*, the court could conceivably have said that it was intrinsic to the concept of "interest" that its payment have some object other than reducing taxes, and therefore that no "interest" had been paid. That would have been somewhat hard to say, however, considering what came before, and given that nothing in the statute indicates that the term "interest" is taken with a special meaning. Instead, the court said simply that this interest was not deductible.⁷² The court held that interest could be deducted only if the underlying borrowing arose from activity that could be called "purposive."⁷³ The adjective is somewhat startling, and one might have thought it entirely

⁶⁷ *Id.* at 736, 739.

⁶⁸ *Id.* at 736.

⁶⁹ *Goldstein v. Commissioner*, 44 T.C. 284, 298 (1965).

⁷⁰ *Id.* at 299.

⁷¹ 364 F.2d at 737-38.

⁷² *Id.* at 740.

⁷³ *Id.* at 741.

applicable to Mrs. Goldstein's desire to reduce taxes. But the court explained that obtaining a tax deduction is not in itself purposive.⁷⁴ More is required, and whatever that is, Mrs. Goldstein did not have it.

Goldstein has been understood (somewhat charitably) in later cases⁷⁵ and commentaries⁷⁶ as embodying a specific refinement of the business purpose doctrine. Starting from the suggestion in *Gregory* that reducing taxes is not in itself a business purpose,⁷⁷ the doctrine posits that a transaction must have the inherent possibility of making a profit, entirely aside from tax effects, in order to fall within Code provisions ostensibly applicable to it. For this purpose, one imagines (although it is never stated), that the imputed income from consumption or ownership of property must be deemed an aspect of "profit," or the interest deduction for all consumer borrowing would be struck down.

But even passing this problem, the difficulties with the doctrine are insuperable. Whole classes of transactions could be shown to be uneconomical absent the effect of particular tax allowances. For example, one of the principal advantages of home ownership is the tax benefit of deductible mortgage interest coupled with the exclusion of the imputed rental income from taxation.⁷⁸ In many cases the purchase of a house with borrowed money is demonstrably uneconomical without this tax benefit, a benefit often fully discounted in the price of housing. Consistently applied, therefore, the *Goldstein* doctrine would wipe out the deductibility of much home mortgage interest—not such a bad result as a matter of policy, but not one commonly thought to be within the province of the courts to bring on unilaterally. The particular ferocity of the outcome in *Goldstein* embodies no consistently applicable general principle but, once again, an aesthetic response to a transaction thought unappealing.⁷⁹

VII

The cases on form and substance have come some distance

⁷⁴ *Id.* at 741-42.

⁷⁵ *E.g.*, *Roemer v. Commissioner*, 69 T.C. 440, 463 (1977).

⁷⁶ *E.g.*, Warren, *The Requirement of Economic Profit in Tax Motivated Transactions*, 59 TAXES 985, 986-91 (1981).

⁷⁷ 364 F.2d at 741-42.

⁷⁸ I.R.C. § 163 (1976).

⁷⁹ I am, happily, spared the need to say more to demonstrate the doctrinal infirmities of *Goldstein* and its progeny because precisely such a demonstration has recently been made in an excellent article. See Warren, *supra* note 76.

past the simple attempt to distinguish genuine transactions from shams. So uncertain are the broader doctrines drawn by the courts, however, that the pattern of two-level holdings, adumbrated in *Gregory* and *Court Holding*, has persisted. Where possible, courts still try to cast transactions in disfavor as shams, before burying them under pronouncements of more sweeping import.

The much-vexed case of *Waterman Steamship Corp. v. Commissioner*⁸⁰ is an example. In that case the taxpayer (a corporation) sold the shares of a wholly owned subsidiary, in which its tax basis was \$700,000. The buyer originally offered \$3,500,000 for the shares. Not wanting a large capital gain of \$2,800,000, the parent corporation rejected the offer but countered with its own offer of a sale for \$700,000, to be preceded by a dividend distribution of \$2,800,000. The buyer accepted this proposal.⁸¹ The subsidiary distributed a \$2,800,000 note to its parent as a "dividend" shortly before the sale of its shares. Shortly after the sale, the buyer lent the (now former) subsidiary of the taxpayer \$2,800,000, which was used to pay off the note.⁸²

Dividends from a wholly owned subsidiary are normally tax-free to its parent.⁸³ This explains the dividend distribution *before* sale of the subsidiary's shares. The subsidiary, however, almost surely had insufficient liquid assets actually to pay a \$2,800,000 dividend in cash, which explains the distribution of a note. The Tax Court found that a dividend had in fact been paid by the subsidiary to its parent before the sale of shares.⁸⁴ The Court of Appeals reversed in an opinion laced with the language of form and substance.⁸⁵

The narrow holding of the court was apparently that in "substance" no dividend had been paid and that the overall transaction was a sale of the subsidiary's stock for \$3,500,000. At this level the opinion is unremarkable but, again, wrong. To be sure, the transaction was economically equivalent to a sale of shares for \$3,500,000 before the dividend, but sales of shares are always at a price that reflects the previous payment of dividends. It is true also that the

⁸⁰ 430 F.2d 1185 (5th Cir. 1970), *cert. denied*, 401 U.S. 939 (1971).

⁸¹ *Id.* at 1187-90.

⁸² *Id.* at 1189-90.

⁸³ I.R.C. § 243 (West Supp. 1982).

⁸⁴ *Waterman S.S. Corp. v. Commissioner*, 50 T.C. 650 (1968), *rev'd*, 430 F.2d 1185 (5th Cir. 1970), *cert. denied*, 401 U.S. 939 (1971).

⁸⁵ *E.g.*, 430 F.2d at 1185, 1192 ("attempt by a taxpayer to ward off tax blows with paper armor"; "economic substance"; "courts will look beyond the superficial formalities of a transaction to determine the proper tax treatment").

subsidiary probably did not have the ready cash to pay a \$2,800,000 dividend. But the creation of claims against corporate assets in the form of debt instruments distributed to shareholders has normally been treated by the IRS and the courts as a dividend.⁸⁶ The succession of events was rapid rather than drawn out, but that was hardly a reason for the individual steps to change their character.

To its dissection of the taxpayer's specific transaction, the court added a statement of general principle. To allow a tax-free dividend would open "a new horizon of tax avoidance" by the circumvention of capital gains treatment "through a pre-sale extraction of earnings and profits."⁸⁷ The inevitable implication of this principle is that there can never be a dividend distribution in close proximity to a sale of shares.

The court's notion of what is necessary to prevent tax avoidance, assuming this to be a legitimate standard, is remarkable. The profits of the subsidiary in *Waterman Steamship* had already been taxed at the regular corporate tax rate for business profits. When the parent was taxed on gain from the "sale" of its subsidiary's shares, these profits were in effect taxed again in corporate solution. And the profits of the subsidiary could still be taxed as dividends upon their ultimate distribution to individual shareholders. Thus a regime of potential triple taxation of the same profits was found necessary by the court to prevent a "new horizon of tax avoidance."

Curiously, the result sought by the taxpayer in *Waterman Steamship* (and decried as a potential "new horizon" of abuse) was unilaterally adopted by the IRS, four years before *Waterman Steamship* was decided, in its 1966 revision of the regulations governing consolidated returns of parent and subsidiary corporations.⁸⁸ To have respected the dividend distribution in *Waterman Steamship* would have given the taxpayer the result now routinely obtained under IRS regulations by parent corporations that sell subsidiaries, a result denounced by no one as "tax avoidance."⁸⁹

⁸⁶ See, e.g., *Bazley v. Commissioner*, 331 U.S. 737, 742-43 (1947).

⁸⁷ 430 F.2d at 1195.

⁸⁸ Compare Treas. Reg. § 1.1502-34A (1955) (generally no adjustment of parent's basis for subsidiary's earnings and profits) with Treas. Reg. § 1.1502-32, T.D. 7637, 1979-2 C.B. 311, 315 (parent's basis in stock of consolidated subsidiary increased by subsidiary's earnings and profits).

⁸⁹ Many of the difficulties inherent in the Fifth Circuit's handling of *Waterman Steamship* are analyzed in Kingson, *supra* note 32. Kingson offers a powerful critique of the case, but then appears to conclude that the true substance of the transaction should be found in

VIII

It is easy enough to criticize, I suppose, and someone having read this far might well ask how the courts could have done better in unravelling form and substance in taxation. For one, they could have paid less attention to the whole idea. More parsing of the statute and specific transactions and less concern with how to save the world from manipulative taxpayers would have led to sounder holdings in all these cases.

The most important inquiry at the threshold is whether a statutory provision draws its meaning from the terms of the statute itself or (and to what extent) from outside. When we are dealing with statutory terms of art, the form-substance dichotomy is a false one. "Substance" can only be derived from forms created by the statute itself. Here substance *is* form and little else; there is no natural law of reverse triangular mergers. The IRS should no more be required to concede a near miss than a taxpayer to be denied the benefit of a formally perfect transaction for want of moral purity.

The harder problem is measuring transactions against statutory provisions that draw their content from life. The ultimate question here is what it is that taxpayers have actually done. This is a difficult sort of inquiry, which requires a grasp of transactions in their complete setting.

Hard grappling with the facts of a case and the inner workings of a statute, although both difficult and intellectually admirable, is frequently passed off as a trivial or excessively "formal" exercise. For one who has gotten that far, the slogan of "substance over form" is as good a means as any to clear the intellectual landscape for an inquiry about the "larger" nature of the statute itself. The latter exercise is in fact quite easy, requiring only the assertion of a statutory purpose that encapsulates one's own tastes, either generally or regarding the transaction under scrutiny.

As Professor Bittker points out, the enshrinement of substance over form has come to serve in the discourse of tax lawyers and judges as a "maxim" of statutory construction.⁹⁰ As with its older relatives—or perhaps like a proto-language after generations of etymological transformation—it is harder and harder to know which way it will cut when it surfaces. Learned Hand himself once

the underlying negotiations, on the principle of *Court Holding*. *Id.* at 883-84. It seems to me that Kingson replaces the approach taken by the court in *Waterman Steamship* with one conceptually even less tenable. See *supra* note 64 and accompanying text.

⁹⁰ 1 B. BITTKER, *supra* note 1, at 4-35 to 4-44.

described "form" and "substance" as "anodynes for the pains of reasoning."⁹¹ In its recent manifestations in decided cases, the slogan has become as much a means of blunting the thrust of the statute as promoting it.

A justification frequently offered for extrastatutory or remedial forays by the courts in tax cases is that the tax laws cannot possibly reach all the artful forms of transaction used by taxpayers to reduce taxes and, therefore, that the courts have an important function in filling gaps left open by an imperfectly expressed congressional intent.⁹² Few myths so persistent are as easily dispelled. It is hard to think of a single case that has ever permanently staunched any fissure in the congressional dyke.

None of the cases reviewed here forestalled the necessity to change the law. Some even required specific corrective responses against their own holdings from Congress and the IRS. Neither the IRS nor the courts need rely on the highly metaphorical language of *Gregory* to prevent dividend distributions from taking on the guise of corporate separations, because the Code has been specifically amended to require first, that the shares received by would-be Mrs. Gregorys represent ownership of an active business undertaking with a five-year history,⁹³ and second, that the overall transaction not be a "device" for the distribution of profits.⁹⁴ The result in *Court Holding* so little comported with desirable tax policy that the outcome of the case in its original setting was reversed by Congress in the 1954 Code.⁹⁵ The IRS was forced to repudiate the principle underlying its victory in *Waterman Steamship* when it became apparent that it favored the taxpayer in cases where individuals rather than parent corporations received distributions from corporations before the sale of their shares.⁹⁶ The IRS has retreated to the position that *Waterman Steamship* is a pure sham transaction case, which it certainly is not.⁹⁷

⁹¹ Commissioner v. Sansome, 60 F.2d 931, 933 (2d Cir.), cert. denied, 287 U.S. 667 (1932).

⁹² E.g., Davant v. Commissioner, 366 F.2d 874, 887 n.27 (5th Cir. 1966), cert. denied, 386 U.S. 1022 (1967).

⁹³ I.R.C. § 335(a)(1)(b) & (c) (West Supp. 1982).

⁹⁴ Id. § 355(a)(1)(B).

⁹⁵ Internal Revenue Code of 1954, ch. 736, § 337, 68A Stat. 1, 106 (1954) (codified as amended at I.R.C. § 337 (West Supp. 1982)).

⁹⁶ See Casner v. Commissioner, 450 F.2d 379, 395, 398 (5th Cir. 1971) (*Waterman Steamship* applied to distributions received by individual shareholders); Rev. Rul. 75-493, 1975-2 C.B. 109 (IRS will not follow *Casner*; *Waterman Steamship* distinguished as "sham" case).

⁹⁷ See *supra* text accompanying note 86.

The *Goldstein* case best illustrates the fecklessness of judicial attempts to make the law "better" by designing it in response to the affairs of a single taxpayer. The perceived abuse in *Goldstein* stemmed principally from two causes. The first was the deduction claimed for prepaid interest, at that time not barred by the Internal Revenue Code. Certainly, the prepayment of several years' interest could be regarded conceptually as a capital expenditure, being the cost of producing the right to use borrowed funds for a period of years. Arguably, then, a deduction should be only ratably allowed. Offsetting this is the fact that the taxpayer has actually parted with the interest and that the lender must recognize income immediately.⁹⁸ The other major problem with the *Goldstein* transaction was the creation of a current interest deduction against ordinary income for the cost of holding an asset that, by virtue of accruing unrealized appreciation, would produce gains both deferred and partly taxed at lower capital gains rates.

Quite possibly these two problems were defects in the tax system. But it certainly was not within the reach of a single decision like *Goldstein* to cure them. The tax result sought by Tillie Goldstein has been prevented independently by at least two subsequent statutory changes. One is a limitation on the deduction of interest on borrowings used to carry investment assets.⁹⁹ The other is a requirement that prepaid interest be deducted ratably over the full period of a borrowing.¹⁰⁰ Either rule alone would have stopped Tillie Goldstein. It is inconceivable that Congress could have been spared the trouble of amending the law by the generalized requirement of a "purposive" transaction asserted in *Goldstein*. The net effect of *Goldstein* was therefore not to improve the law in a way that voided the need for further statutory overlays, but simply to penalize one Tillie Goldstein for having thought that she could rely on a clearly stated Code provision allowing a deduction for "interest,"¹⁰¹ which no one denied that she paid.

The sort of "creative" jurisprudence found in the cases on form and substance cannot, in the end, be justified by any demonstrable needs of sound tax administration. It has, however, become the norm, and one wonders why.

⁹⁸ Indeed, objections to prepaid interest might also invalidate the allocation of large amounts of interest to the early payments of a mortgage.

⁹⁹ Tax Reform Act of 1969, Pub. L. No. 91-172, § 227, 83 Stat. 487, 574 (current version at I.R.C. § 163(d) (West Supp. 1982)).

¹⁰⁰ Tax Reform Act of 1976, Pub. L. No. 94-455, § 208, 90 Stat. 1520, 1541-42 (codified at I.R.C. § 461(g) (1976)).

¹⁰¹ I.R.C. § 163(a) (1976).

One reason is that judges have aspirations. Little attention is drawn to those who hew narrowly to technical rules. The painstaking process of examining transactions and statutes to determine whether they concord promises little glory. In a society that has always looked to courts for strokes of statesmanship, it is easy enough to understand a judge's temptation to cut through, rather than unravel, the Gordian knot. A simpler variant of this attitude is the desire not to look naive, to understand what is "really going on." Many of the judges who have written opinions in this area display the tone of one who wants very much not to be taken in.

A recent Tax Court case, *Carriage Square, Inc. v. Commissioner*,¹⁰² is both amusing and unnerving in its surrender to this tendency. The underlying issues are unimportant, because it little matters whether the court was right or wrong. A concurring opinion contains the following thoughts:

All the members of the Court recognize that the tax avoidance scheme of Arthur Condiotti and his accountant-tax adviser, William P. Barlow, cannot be allowed to stand. It is an obvious attempt, and a somewhat crude attempt, lacking in legitimate business purposes, to spread large anticipated sums of ordinary income among several taxpayer[s] The only disagreement among the members of the Court is how best to set aside the tax avoidance scheme.¹⁰³

The opinion then goes on to scourge the taxpayer with a variety of epithets.¹⁰⁴ Six judges agreed with this concurrence. To be sure, neither Learned Hand nor Hugo Black would ever have written such words into an opinion, but it is also hard to imagine that any judge would feel licensed to follow a pure gut response in deciding a tax dispute if *Gregory* and *Court Holding* had gone the other way.

On the whole, law professors do not help much either. It is their wont to decry "formalism" and glorify the ends of "policy" in the resolution of disputes. It is not uncommon for professors to regard—and teach—the process of legal interpretation as a vehicle for their own aesthetic preferences, which cover the range from allocative efficiency to distributive justice. Whatever the merits of this style of legal analysis in general, in tax matters it is a fertile

¹⁰² 69 T.C. 119 (1977).

¹⁰³ *Id.* at 130-31 (Goffe, J., concurring).

¹⁰⁴ *Id.* at 133 ("not acquired in a bona fide transaction"; "scheme to avoid tax"); *id.* at 134 ("reek with suspicion"); *id.* at 137 ("flunked all of the tests").

source of bad law.

If not the taxpaying public or the fisc, who ultimately benefits from this approach? The only unequivocal beneficiary is the tax bar. The heavier the layers of judicial divination superimposed on the Internal Revenue Code, the richer tax lawyers are apt to get. The development of an exquisite set of intuitions about what kinds of transactions the courts "like" and "don't like" has become a large part of what tax lawyers sell.

After *Court Holding*, a lawyer could with a certain smug veracity tell a client who had thought it a good idea to save taxes by liquidating a company before a sale, "You should have called me months ago—now you're in trouble." Indeed, it would not take too many cases like *Court Holding* to justify the injunction not to take a deep breath without calling a tax lawyer.

Some of this is inevitable. Clients will rarely read the tax laws or the decided cases as accurately as their counsel and will always have some reason to fear that they may have missed something. To the extent that every transaction has to run the gauntlet of an array of extrastatutory standards, however, tax lawyers' contribution to the GNP deflator will be all the greater.

To be sure, all of this matters less than war or famine, and we shall all manage to lurch along even with this additional dead weight on our tax system. Still, I believe that if *Gregory* had gone the other way (and all that that entails had ensued), we would now have a more readily fathomable demarcation between the respective spheres of statutory provisions and judicial intuition.

IX

Remembering my starting point, I should add that it was not—nor should it have been—Professor Bittker's mandate to scour the tax cases for unsound pronouncements. The most important function of a tax treatise is to aid in giving advice. And there is no denying that tax lawyers must, in advising their clients, heed every one of the cases examined here, notwithstanding the sort of misgivings an academic reviewer might muster.

Overall, *Federal Taxation of Income, Estates and Gifts* serves the ends of tax lawyers so well that with it Professor Bittker has cemented his already immense reputation. Another actor in this story, however, now mostly forgotten, also deserves a word of praise—a word necessarily directed to his heirs. It was Judge Sternhagen of the Board of Tax Appeals who, in the original opinion in *Gregory*, made the clearest and most defensible statement I

have yet encountered on the subject of form and substance in taxation.¹⁰⁵

¹⁰⁵ See *supra* notes 35-37 and accompanying text.